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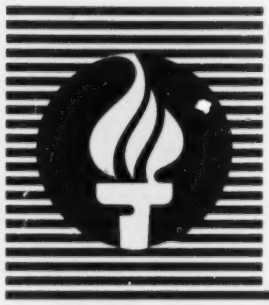

The Conference Board

Reshaping Financial Services

- *vigorous lobbying on deregulation*
- *industry consensus elusive*
- *debate pits large against small firms*
- *consumers growing querulous*

Research Bulletin No. 213

Summaries of Federal Legislation Currently Relevant To Financial Service Companies

The ***McFadden Act*** of 1927 prohibits national banks from branching across state lines and requires that they conform to the branching regulations of the state in which the are located.

The ***Glass-Steagall Act,*** or the Banking Act of 1933, was passed following a series of Depression-era bank failures. Under the Act, commercial banks are prohibited from underwriting and dealing in corporate securities; investment banks are forbidden to engage in commercial banking activities.

The ***McCarran-Ferguson Act,*** passed in 1945, provides a limited antitrust exemption for insurance companies (allowing them to share data in order to predict future losses and so on) and acknowledges the authority of the States to regulate and tax insurers.

The ***Bank Holding Company Act*** of 1956 defined a bank holding company and established the Board of Governors of the Federal Reserve System (the Fed) as the supervisor of such firms. The Act specifically defines the Fed's powers to review certain categories of bank holding company acquisitions, mergers and consolidations. Revisions to the Act in 1966 and 1970 redefined the word "bank," classifying it as an institution that accepts deposits withdrawable on demand (as well as making commercial loans). These changes also expanded the definition of bank holding company to include those that control only one bank and to allow bank holding companies to acquire interests in certain "nonbank" activities.

The ***Securities Acts Amendments*** of 1975 gave the Securities and Exchange Commission (SEC) a mandate to help develop a national market system for securities transactions and a system for clearance and settlement of these transactions. It reinforced a SEC ruling made earlier that year that struck down the use of mimimum brokerage commission rates on securities exchange transactions. Prior to this legislation, fixed commission rates had been in effect for over 150 years. Following this rate deregulation, many firms, including the affiliates of some bank holding companies, began to offer discount brokerage services.

The ***Depository Institutions Deregulation and Monetary Control Act*** of 1980 expanded the loan-making authority of savings and loans and mutual savings banks beyond mortgage lending, authorized automatic transfer services for banks, and negotiable orders of withdrawal (NOW) accounts for depository institutions. The Act authorized a phasing out of the Federal Reserve's Regulation Q by the end of 1986 (the regulation had set limits on the amount of interest commercial banks could pay on time deposits.) All depository institutions were made subject to reserve requirements (funds held against customer deposits) but they were also given access to Federal Reserve services such as check clearing and the discount window (borrowing privileges in order to meet temporary liquidity needs).

The ***Garn-St.Germain or Depository Institutions Act of 1982*** was aimed at helping depository institutions (especially thrifts) compete with the Money Market Mutual Funds being offered by securities firms. All depository institutions were authorized to offer money market deposit accounts which were exempt from the "Regulation Q" interest ceilings. Also, savings and loan and mutual savings banks were allowed to diversify their loans further away from mortgage lending, putting them on a more equal footing with commercial banks. Federal depository insurance agencies (the FDIC and FSLIC, see pages 5 & 6) were also given expanded emergency powers to deal with "financially distressed" institutions.

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Reshaping Financial Services

by

Kathryn L. Troy

All businesses (and most consumers) are affected by the reshaping of the U.S. financial services industry. The process already influences the ways a company raises capital, manages assets, and structures benefit programs. Further changes may determine with whom a company does "financial" business, at what cost, and with what risk.

Recent changes have been more evolutionary than revolutionary, but for many the ultimate goal is a more integrated financial services system. Traditional distinctions between commercial, thrift and investment banks are eroding, as are regional and state boundaries. The ways in which the insurance business operates are also altering. Some financial services executives say that their firms are already positioned for what will be a very different marketplace. "In the next 25 years there will be about 30 to 40 surviving financial institutions that can reach the consumer with all the necessary products, manufactured and serviced under one roof. These giants will be surrounded by numerous specialty houses," says an executive in an insurance firm that has now diversified.

But even as their vision of their industry takes a more substantial form, executives in many major banking, insurance, securities and commercial firms find that its full realization continues to elude them. Regulatory barriers at state and federal levels present one obstacle.(See box.) Yet, deregulation is certain to bring some dislocation and may result in hardship for smaller companies. "The struggles in financial-service deregulation seem to be lining up big companies against small companies, not insurance or securities firms against banks," says a government-affairs executive in a major firm. "At the state level, the small firms are still potent, but at the federal level the big ones are starting to exert influence."

How quickly will the structure of the industry change? The 100th Congress is considering new banking-industry legislation; a new Chairman, Alan Greenspan, is scheduled to take over at the Federal Reserve Board by Fall, 1987. Observers inside and outside financial services companies wonder whether regulatory change and a restructuring of the financial system will be underway before the 1990's.

This study profiles major issues in this industry, outlines areas likely to change most dramatically, and examines their significance to the way companies and consumers do business. The report was compiled from questionnaire data as well as interviews with government-affairs executives in 70 major financial services companies. Relevant documents and publications were also reviewed.[1]

Federal Legislation: Regulate, Deregulate or Just Wait?

Pressure has been building for Congress to revamp the structure of financial services in the United States. The question is how to effect that change. The interests of large and small companies in banking, insurance, and securities (as well as diversified commercial companies with financial services subsidiaries) often conflict. Companies cannot accept *piecemeal* solutions—a benefit bestowed on one group often penalizes its competitors. Yet, financial services executives have difficulty agreeing on a recipe for *comprehensive* reform of the system. (See Table 1 for details on how financial services firms are lobbying.) The questions under debate involve significant alterations in the way financial instruments are handled. Major challenges to legislators, regulators and the courts include these:

- Should banks be allowed to underwrite securities, insurance and/or offer a range of real estate services?
- Should nonbank companies be allowed to offer traditional banking services, such as accepting deposits that may be withdrawn on demand or making commercial loans?

[1]A detailed Conference Board report on public affairs in the financial services industry will be in print shortly.

Table 1: Regulatory Issues: Direct Lobbying by Financial Services Companies[1]

Issue	Sector[2]	Federal Level: Number of Companies	Federal Level: Percent Lobbying Directly	State Level: Number of Companies	State Level: Percent Lobbying Directly
Maintaining laws/regulations preventing expansion of commercial banks into securities underwriting or insurance	I,S	29	60[a]%	21	50[a]%
or					
Changing laws to allow banks into:	B				
Securities underwriting		31	85	13	70
Insurance		31	75	18	60
Changing laws and regulations to allow nonbank banking	B	31	60	19	30
	I,S	32	50	19	40
Changing laws and regulations to allow interstate banking:	B				
Within specific regions		22	60	28	70
Nationwide		28	45	23	40
In special cases		28	45	24	40
Repeal of the McCarran-Ferguson Act	I	26	60	12	60
Legislation/regulation to allow demutualization of companies[3]	I	21	20	22	45

[1]Direct lobbying includes independent activity as well as participation in efforts by ad hoc coalitions or business organizations. Those firms not engaged in direct lobbying are either monitoring the issue or relying on their trade association to lobby for them.

[2]Key: B = Banking; I = Insurance; S = Securities and Diversified Financial

[3]Mutual insurance companies are owned by their policyholders. In recent years, some mutual companies have sought state permission to "demutualize" and convert to a stock company. States such as New York, Alaska and Hawaii prohibit such conversions; other states provide guidelines to insure that such conversions are in the best interests of the policyholder; while still other states have yet to address the issue.

[a] Percentages are rounded.

- Should banks be allowed to expand operations through acquisition or branches across state lines, within specific regions, or nationwide? At what pace?
- Must the risk incurred by financial institutions be subject to greater regulatory oversight?

Through the Loophole

To some extent, experts note, the industry's traditional barriers have already begun to erode, even if they have not been formally dismantled. Talk of exploiting legislative "loopholes" is common in the financial services industry. (See box.) Banks have tried to enter insurance through the "South Dakota" loophole and to sell securities through loopholes in the Glass-Steagall Act. The Bank Holding Company Act has not prevented banks, nonbank-financial companies (such as Travelers, John Hancock, and Merrill Lynch) and even diversified companies (such as Sears) from setting up limited-service, or "nonbank" banks. As regulatory agencies and the courts struggle with the issues raised by these developments, financial companies have been lobbying at the federal level—often with conflicting agendas. Some want to have the loopholes closed; others want a broadening and redefinition of powers for their sector—or for all the players in the financial services arena.

Trade Association Role

The battle lines among the sectors of the financial services industry have been given clear definition at the trade association level by such groups as the Securities Industry Association (SIA), the Independent Bankers Association, the American Council of Life Insurance (ACLI), and various insurance underwriter (agent) groups. Small bankers, such as those who are members of the Independent Bankers Association, see limited-service banks as a serious competitive threat. For securities brokers, insurance agents and many insurers, the prospect of competing with their local banks is similarly threatening.

The existence of limited-service banks as well as the push by big banks for national banking have produced a schism within banking's major trade group, the American Bankers Association. Small banks oppose any federal law authorizing nationwide banking because they fear that the large multinational banks will devour them and destroy the character of community banking. Instead, they prefer a state-by-state or

regional approach that will give small banks a grace period. That would allow them to consolidate with other small or regional banks before the large "money-center" banks could make acquisitions or branch into their state.

The Legislative Score Card

No major new financial-industry legislation has been passed at the federal level since 1982. Although many insurance and securities executives believe this is a good thing, some exasperated banking executives blame Congress for ducking its responsibilities in the banking area. "From a large bank's viewpoint, there has been an increase in attempts at regulation, including those to increase reporting, capital and reserve requirements," says a government-affairs executive. "There have been regulatory rulings that allowed us into certain areas we were not in before. But Congress has done nothing whatsoever to deregulate the banking industry. . .Congress must recognize that it has set up a protective pond in which the securities industry may fish without competition."

In 1984, 1985 and 1986, Congress did formulate banking legislation, but the Senate and the House were unable to agree on a final bill. Fueling the 1987 legislative drive is the need to recapitalize the agency that insures savings and loan banks—the Federal Savings and Loan Insurance Corporation (FSLIC). Record numbers of failures among thrift institutions since 1984 have depleted its resources.

Meanwhile, bankers say that deregulation of the deposit side of their business has increased their cost of money and strained their profitability.[2] Full deregulation of banking would enable them to diversify their assets, increase their profits and spread their risk, bankers contend. Early in 1987, industry observers believed that prospects finally looked good for banks to get legislative approval of expanded securities powers—a major goal for which they have been lobbying aggressively. The Federal Reserve had granted some of these powers provisionally to a New York bank (see page 6). In a speech to the New York Banker's Association, the New York Federal Reserve Bank's President, E. Gerald Corrigan, proposed significant reforms that would extend the powers of both banks and securities firms. Still another early 1987 milestone was the formation of a new coalition of financial services companies, the Mayflower Group. With members drawn from companies such as Citicorp, American Express, Sears, Merrill Lynch and John Hancock, the group's agenda is broader than "banking degregulation"—it is pressing for a restructuring of the financial services industry.

By late March, 1987, the immediate outlook for deregulation of banking seemed less than promising. The Senate approved a banking bill that would recapitalize the FSLIC. However, the bill also placed a moratorium on expanded powers for banks (in securities, insurance and so on) and on the creation of new limited-service banks, although the 166 existing institutions could continue to operate. There are consumer measures as well: Banks would be required to give customers access to the money they deposit by check within six or seven days and to cash government checks without a service charge. (The presenter would have to have an ID card issued by the bank.)

By July, 1987, a House-Senate conference committee agreed on comprehensive banking legislation. But the Reagan administration opposed several provisions in the conference bill, and threatened a Presidential veto. Late in the month, administration officials struck a compromise with the chairman of the Senate and House banking committees. There were three key elements: The FSLIC recapitalization would be raised from $8.5 billion to $10.8 billion; regulatory leniency for troubled thrift institutions would be phased out after three years; and both financial and commercial firms would be allowed to ac-

[2]In March, 1987, the FDIC reported that the total income of federally-insured commercial banks had declined by 1.4 percent in 1986—the first decline in 25 years. The Agency's Chairman tied most of the decline to loan losses due to continuing problems in agriculture and energy. In May, 1987, a Federal Reserve Study reported that an unusually high percentage of 1986 bank profits come from the sale of securities rather than from interest on loans.

Legislative Loopholes

South Dakota Loophole: In 1983, the state of South Dakota enacted legislation that allowed state-chartered subsidiaries of bank holding companies to engage in all facets of the insurance business. Insurance is basically state-regulated, and many insurance agents and companies want to discourage other states from passing legislation that would open similar loopholes. Thus, insurers have campaigned for national legislation to prevent state action. Connecticut's Senator Christopher Dodd offered an amendment to the "Garn Bill" passed by the Senate in 1984. The amendment would prohibit states from allowing state-chartered banks to sell insurance within their jurisdiction. The bill never became law, but the insurance industry continues to support the "Dodd Amendment" and hopes to keep it alive for future legislation.

Nonbank Bank Loophole: Under the Bank Holding Company Act, a bank is an institution that makes commercial loans and accepts deposits that are withdrawable on demand. Limited-service institutions may skirt this definition by offering NOW accounts, which technically do not give depositors the legal right to withdraw upon demand; or they may not take deposits but may make loans, offer credit cards, and provide other financial services. By some variation on this strategy, they manage to be "nonbank" banks. Companies such as Sears, Travelers, Merrill Lynch and John Hancock have such operations and have an interest in keeping the loophole open, while small banks see a competitive threat and are adamant about closing it. Larger banks generally favor keeping the loophole open, either because it gives them a possible vehicle for expansion across state lines, or because they see it as a bargaining chip that may be useful when negotiating other legislative concessions.

Glass-Steagall Loophole: Although the Glass-Steagall Act prohibits banks from trading and underwriting corporate securities, several major banks have maneuvered around the prohibition. They have been backed by their regulatory agencies, but challenged in the courts by the Securities Industry Association (the SIA). Many of the recent court and regulatory rulings have favored the banks. The securities industry continues to fight for legislation that would close the loophole, while banks are pressing for an even greater expansion of powers in the securities area (municipal revenue bonds, mortgage-backed securities and so on). (See pages 6 and 7.)

quire insolvent thrift institutions that have assets of $500 million or more. Controversial provisions that remain intact are (1) a ban on the establishment of new limited-service banks and (2) a temporary ban (until March, 1988) on any new regulatory rulings that would authorize expanded powers for banks. The bill must still be cleared through the House Rules Committee and approved by members of the House and Senate. Although the bill slows the Reagan Administration's campaign for deregulation, the President is expected to sign it—if it survives in its present form.

Regulators and Courts Fill the Gap

Limited-service banking, securities powers for banks, and expansion of banks into insurance are issues that have also been contested in the courts and by the bank regulatory agencies. The Reagan Administration favors further deregulation and has reportedly encouraged regulatory agencies to find legal interpretations and make rulings to promote this end. The Federal Reserve Board (the "Fed"), which is responsible for overseeing the state banks that are members of the Reserve System, as well as bank holding companies, has probably been the most conservative in its interpretations. Yet it has leaned toward giving broader securities powers to banks. It may favor deregulation more strongly with Alan Greenspan as its Chairman, according to many.

The other two agencies involved in banking regulation have been more lenient in their stance—at least on some issues. These include the the Office of the Comptroller of the Currency, which has primary responsibility for nationally-chartered banks, and the Federal Deposit Insurance Corporation. The FDIC shares with state banking authorities supervision of state-chartered banks that are not members of the Federal Reserve System but are covered by federal deposit insurance.

Commercial Paper and Other Securities

Probably the biggest issue that has faced the courts and regulators of banking practices has been the banking industry's drive into securities markets. The SIA which has brought many suits, has had victories in the lower courts. Decisions in appeals to the higher courts have generally favored the banking industry. These are the outcomes of some recent court decisions:

• As of December, 1986, courts have ruled that a bank may place but not underwrite commercial paper (short-term, unsecured corporate debt). Interpretations to date indicate that a bank may act as an adviser or agent for a corporation making an offering but may not purchase the paper or some unsold part of the offering for later resale to interested customers. This battle dates back to the late 1970's when the Federal Reserve was first asked to bar placement of commercial paper by Bankers Trust Company. At the time, the Fed ruled that commercial paper was not a security, but this interpretation was negated by a September, 1984, Supreme Court ruling. Saying that commercial paper is a security, the Court asked the Fed and a lower court to decide whether Bankers Trust's activity constituted underwriting under Glass-Steagall. The Fed ruled in favor of Bankers Trust, but in early 1986, a Federal District Court found in favor of the SIA, saying the activity is a violation of Glass-Steagall.

A December, 1986, Appeals Court decision overruled the District Court decision and again cleared the way for commercial banks, but the SIA appealed this decision to the Supreme Court. In June, 1987, the high court refused to hear that appeal. Meanwhile a number of large New York banks are attacking on the regulatory front and have asked the Fed to allow them to underwrite commercial paper as well as to package and sell such other securities as municipal revenue bonds, mortgage-backed securities, and consumer-related loans. The agency sent several messages to Congress urging it to overhaul the Glass-Steagall Act and promised to rule on the New York banks' request by Spring, 1987.

As a first step, in March of 1987 the Fed ruled that Chase Manhattan Corporation may underwrite and deal in commercial paper through its commercial lending subsidiary. Late in April, by a 3 to 2 vote, it gave three bank holding companies (Bankers Trust New York Corporation, Citicorp and J.P. Morgan & Company) limited authority to underwrite and deal in municipal revenue bonds and mortgage-backed securities through subsidiaries. (J.P. Morgan also received permission to underwrite and deal in commercial paper.) Although he favors expanded securities powers for banks, the Fed's Chairman at the time, Paul Volcker, dissented from the ruling on the grounds that the agency does not have the statutory authority to grant banks these powers. The SIA announced plans to challenge the agency's ruling in a federal appeals court. Moreover, pending legislation could suspend the Fed's decision.

• Regulation of *discount brokerage* services offered by banks has embroiled the courts, the Securities and Exchange Commission (SEC), which oversees the securities industry, and the Comptroller of the Currency. As the name implies, discount brokers may buy and sell securities for customers at smaller commissions than full-service brokers, but they do not offer investment advice. As early as 1957, the Office of the Comptroller of the Currency (OCC) relaxed previous interpretations of Glass-Steagall that did not allow banks to receive a profit for brokerage transactions they made for the convenience of bank customers.

In 1982, the OCC went beyond this interpretation to say that banks could offer discount brokerage services to customers and noncustomers—provided this was done through a subsidiary. In July 1987, a federal appeals court upheld a 1986 decision by the Federal Reserve on a related matter. The Fed gave the subsidiary of the U.S. holding company of a London bank permission to offer both brokerage services and investment advice to institutional and wealthy clients.

There have also been questions about which agency should regulate the discount brokerage operations of banks. In 1985, the Securities and Exchange Commission moved to require banks engaged in discount securities services to register with the agency as broker-dealers, but a federal appeals court ruled in 1986 that the SEC had overstepped its authority. The decision was particularly important to small banks; a registration requirement would make it costly for them to enter this field.

Late in April, 1987, the SEC announced plans to ask Congress for the authority to regulate the securities operations of commercial banks. The SEC's position is that bank-brokerage activities should be conducted through separate corporate affiliates under that agency's oversight.

- Discount brokerage by banks has also been challenged by the SIA under the McFadden Act, which restricts the degree to which banks can establish branches. In 1984, the Supreme Court ruled that discount brokerage services of bank holding companies are not subject to the Act—clearing the way for many large banks to offer these services both inside and outside their home states. Early in 1987, the Supreme Court ruled (in SIA v. Clarke) that national banks, not just holding companies, may also operate discount brokerage outlets without being subject to McFadden Act restrictions, since these services are not "core banking activities."

Interlopers in Insurance?

On the legislative front, the insurance industry has been protecting its turf by backing the Dodd Amendment (see box, page 5.) There is also regulatory and court activity. Generally, bank holding companies are limited to selling credit-related insurance products to bank customers, but there are exceptions. For example, sixteen bank holding companies are allowed to sell insurance nationwide because they established their operations before 1956, when the Bank Holding Company Act prohibited it.

Special provisions also apply in small communities: A Federal Reserve ruling allows bank holding companies whose principal place of business is in small rural towns (those with a population of 5,000 or less) to act there as a general insurance agent. The Fed recently amended this ruling. Now, a bank holding company or its subsidiary may act as a general insurance agent using lending offices in communities of 5,000 or fewer residents. (Such a community does not have to be its principal place of business.) It may also solicit insurance business from outside the small community, provided it conducts transactions from its office there. Trade associations representing insurance agents have filed suit on this ruling and await a hearing.

In the meantime, the Comptroller of the Currency issued a ruling authorizing a bank in Oregon to sell insurance both inside or outside the state. (The bank or its branch must be located in a town of 5,000 or fewer people.) Many in the insurance industry view this as an open door through which banks will establish branches in small towns with the intention of using them to sell insurance nationwide. Several insurance trade groups have filed suit on this ruling, claiming the decision violates the National Bank Act and the Bank Holding Company Act.

Yet banks and insurers are also involved in cooperative arrangements. In a 1986 survey by the Life Insurance Marketing and Research Association, 54 of its 253 responding members reported that they have marketing arrangements with banks or savings and loans. A handful of companies (12 insurers and 2 independent agencies) had cooperative arrangements in which they sold insurance in bank lobbies.

Limited-Service Banks

With banks making incursions into their territory, insurance companies and securities firms have looked to the "nonbank" bank as a way to widen their powers. Large banks have seen them as one means to establish a toehold in states where they are not otherwise allowed to branch. Only a large handful of nonbank banks were in operation before 1985, when small-bank trade groups and other organizations in Florida were successful in getting a district court to issue a preliminary injunction prohibiting the Comptroller of the Currency from chartering additional nonbank banks. Several hundred companies have applied for such charters.

Federal Reserve Chairman Paul Volcker has opposed nonbank banks, partially because the diverse interests of a commercial parent company might prejudice the loan decisions of a banking subsidiary. The Fed attempted to extend one of its regulations in order to give itself jurisdiction over limited-service banks and curb some of their activities. This move was invalidated by an appellate court in 1984, and in January, 1986, the Supreme Court ruled that the Fed had exceeded its authority (Board of Governors of the Federal Reserve v. Dimension Financial Corporation). The Court noted that new legislation would be necessary to regulate nonbank banking.

In another case, the Supreme Court also ruled against a lower court decision that had challenged the charter of a limited-service bank in Florida. A New York firm, U.S. Trust Corporation, had obtained the charter from the Federal Reserve in 1984. The State of Florida, the Florida Bankers Association, and other groups sued the Fed, saying that granting the charter was a violation of the Bank Holding Company Act. In a May, 1985, decision the U.S. Court of Appeals for the 11th Circuit in Atlanta said that, although not technically a bank, the nonbank entity was a bank for all intents and purposes. However, early in 1986 the Supreme Court vacated that decision. It suggested that the lower court review its ruling, taking into account the high court's decision in the Dimension Financial case.

Late in 1986, the 11th Circuit Court reversed its 1985 decision and upheld the charter of the New York company's nonbank-banking operation. The Conference of State Bank Supervisors and the Florida Department of Banking and Finance appealed the 11th Circuit Court's 1986 decision to the U.S. Supreme Court. In April of 1987 the high court refused to hear the appeal (Conference of State Bank Supervisors v. Board of Governors).

Large diversified financial companies and trade groups such as the American Financial Services Association have hailed these decisions as victories. No new nonbank-banking charters can be issued by the Comptroller of the Currency, however—the Comptroller's office is still under a preliminary injunction from a Florida district court. Late in 1986, the Comptroller petitioned to have this injunction removed, and it awaits the district court's decision. Moreover, proposed federal legislation would place a ban on new limited-service banks.

Too Much Risk; Too Little Responsibility?

Despite movement toward deregulation, the activities of

Table 2: Safety and Soundness Issues: Direct Lobbying by Financial Services Companies[1]

Issue	Sector[2]	Federal Level		State Level	
		Number of Companies	Percent Lobbying Directly	Number of Companies	Percent Lobbying Directly
Risk-based capital reserves (higher levels of reserves to be set aside for risky loans)	B	30	60[a]%	16	30[a]%
Risk-based premiums for FDIC insurance	B	30	60	15	30
Accountability for off-balance-sheet liabilities (bank guarantees, loan commitments)	B	29	60	16	25
Restrictions on bank use of market instruments such as swaps and commercial paper	B	28	45	15	20
Increased reserves to be set aside to cover insurance losses	I	22	50	21	55
Adoption by states of legislation based on a Model Guaranty Association Act	I	19	40	25	65
Laws and regulations dealing with the activities of financial planners	I,S	29	7	24	20

[1]See Table 1, note 1.
[2]Key: B = Banking; I = Insurance; S = Securities and Diversified Financial
[a] Percentages are rounded.

banks, insurers and securities firms are under increased scrutiny. Legislators and regulators question whether insurers should be placed more completely under federal antitrust laws, whether financial planners need greater oversight, whether corporate takeover fever has led to abuses of the securities laws, and whether banks are risking too much in their quest for improved profits.

Safety and Soundness in Banking

In 1984, the imminent failure of Chicago's Continental Illinois Corporation (a bank holding company) brought the FDIC into the banking business when it purchased a large portion of the corporation's stock and installed a new Board of Directors. Small banks wonder whether they would be accorded the same treatment or allowed to fail. The controversial move helped bring to the surface banks' concerns about their share of FDIC insurance. Why should the premiums of well-managed banks increase as more banks fail, they argue—why not make premiums risk-based? This issue has inspired coalition lobbying among more than half of the companies surveyed for this study (See Table 2 for information on lobbying related to safety and soundness issues).

Regional economic slumps in oil, farming and real estate sales—as well as third-world loan problems—continue to hurt the banking industry. After a record 145 bank failures in 1986, the Chairman of the FDIC warned that in 1987 the fund might record the first loss in its 52-year history. Just over 50 federally-insured banks failed in the first quarter of 1987. Added to this are about 400 seriously insolvent thrift institutions that are taxing the depleted resources of the FSLIC. Regulators are at work trying to match failing banks with healthy institutions in other regions of the country and to facilitate acquisitions. To sweeten the package for the acquiring bank, the FDIC is offering special interest-earning notes. The Fed is also considering the elimination of some of the barriers between an acquiring bank holding company and an insolvent thrift it acquires—allowing joint marketing and sales, joint advertising, and the like. (Acquisition of a failed bank is one method large banks have used to get access to markets in states where they are not otherwise allowed to operate.)

While those who favor deregulation point to increased competition as a good that will benefit both the industry and the public, some observers take a less rosy view. They believe that competition is forcing banks to pay artificially high interest rates to attract deposits. With their cost of money so high, observers say, banks are making increasingly risky investments in order to maintain an acceptable level of profit. The Fed, the Comptroller of the Currency, and some legislators have suggested that the reserves that banks must set aside to cover losses be based on an assessment of the level of risk in their portfolio of assets. For example, loans to third-world countries would require higher levels of reserves than investments in money market instruments such as government securities.[3] Such risk-based capital requirements would have a major effect on large banks—over half of the banks participating in this study report that the are active in coalitions lobbying this issue. (Whether they oppose it or favor it depends upon their size and the level of risk in their portfolio.)

[3]In May, 1987, Citicorp announced that it would add $3 billion to its loan-loss reserve to provide for possible shortfalls in loan repayments by third-world countries. Although this means that the firm will register a record $2.5 billion loss for its second quarter, industry analysts see the move as an attempt to put third-world debt problems behind the bank and to strengthen its competitive position. Several other major banks have followed the Citicorp lead.

Off the Balance Sheet

In the meantime, the search for profits among large banks has created other quandries for regulators. Banks are acting as middlemen: they make commitments in which they agree to step in and complete a deal if one of the participants should default; they engage in "swaps" of foreign currency for dollars (or vice-versa); they likewise swap fixed for variable interest rates; they offer standby letters of credit which guarantee that a client purchasing goods will make payment.

Usually, banks have to make good on only a portion of these commitments, so they treat them as "contingent liabilities." Actual assets and liabilities need to be accounted for on the bank's balance sheet—and these are used by the Fed to calculate the level of capital reserves the bank must maintain. The "off-balance-sheet" items escape that treatment.[4] The Fed is examining this situation, hoping to devise a fair method for requiring sufficient capital reserves by banks to cover their risk adequately.

Buyouts and Insider Trading

As reports of growing numbers of acquisitions, mergers, leveraged buyouts, or threatened takeovers by "corporate raiders" escalated in 1985 and 1986, members of Congress began to wonder whether current laws were being abused and new legislation was needed. More than 60 separate takeover bills were introduced in the 99th Congress, but each had only a few sponsors and there seemed to be no consensus about what action should be taken. In 1986, the SEC prosecuted participants in a major insider-trading scandal. Late in the year, it dropped a new bombshell: Ivan Boesky, the best known of the New York arbitragers (investors who commit large amounts of capital to purchase the stocks of companies that may announce a major deal, such as a merger) had admitted to trading on insider information and implicated others on Wall Street. This revelation seemed to confirm the worst fears of some in Congress that such abuses may be widespread and need to be curbed. Senator Proxmire, head of the Senate Banking Committee in the 100th Congress, is promising to hold hearings on the subject and is reported to be considering various legislative options.

The SEC, backed by the securities industry, maintains that it has adequate powers to curb such abuses. Nevertheless, as new abuses continue to be unveiled in the early months of 1987, pressure mounts for the agency to (at the very least) develop a better definition of insider trading. Some observers are calling for much broader action, fearing that the widening scandal might develop into a backlash against all of corporate America, or at least its investment banking firms.

Financial Planning

Congress has also been questioning the SEC's ability to regulate another segment of the financial industry—the fast-growing profession of "financial planning." There are varying estimates of the total number of individuals offering these services, but included are some 10,000 investment advisers registered with the SEC (up from 4,000 five years ago) and an estimated 50,000 to 60,000 personal financial planners (up from a few thousand in 1981). Investment advisers have been required to register with the SEC since the passage of the Investment Advisers Act of 1940; their turf has generally been restricted to advice about securities and similar investment options. Financial planners provide similar services but also give advice in other areas such as insurance, taxes or real estate. Most states require that financial planners register with them, but there is little uniformity in their laws and requirements.

In the recent past, advice given by some in the profession has been suspect (investors may be encouraged to buy stocks in which the adviser has a financial interest) or even criminal—in one notorious case, clients were urged to invest in a fraudulent tax shelter that involved sales of meat and pelts from a "super rabbit."[5] Concerned that the SEC was not effectively policing the growing ranks of planners and advisers, a Congressional subcommittee held special hearings in mid-1986. The SEC, the securities industry and groups representing insurance agents (whose activities sometimes meet the definition of financial planning) resisted the notion that additional legislation is needed. The latter two groups also reject a proposal of one professional association that the industry establish new self-regulatory bodies. Rather, they support stronger enforcement of existing regulations and more federal/state cooperation. No Congressional action was taken in 1986, but observers say that the issue did not die with the 99th Congress. About 20 percent of the insurance and securities companies participating in this study worked in coalitions to lobby on this issue, while almost 40 percent saw it as an issue to be addressed by their trade associations.

Crisis, Competition and The McCarran-Ferguson Act

Insurance companies are primarily state regulated, but during 1986 there was concern at the federal level due to what were perceived as problems in the pricing and availability of liability insurance. Although the issue most directly involved property and casualty insurers, sufficient legislative activity took place so that the status of insurers in general came into question. Bills which would have repealed, (or in the case of another bill, restricted) the McCarran-Ferguson Act were suggested. The act, in force since 1945, exempts insurance companies from many of the provisions of federal antitrust law, allowing firms, for example, to pool information. This sharing of data enables insurers to better predict losses, establish actuarial standards, and set rates.

Those advocating repeal of the McCarran-Ferguson Act say that under the current law the public is not adequately protected against price-fixing by insurance companies. Insurers point to the plethora of state regulations to which they adhere and believe that repeal of the exemption would cause dislocations in the industry and force many small companies out of business, thus decreasing competition.

[4] For more information, see Robert A. Bennett, "Worrisome Bank Obligations." *The New York Times*, June 27, 1985.

[5] See Gary Weiss, "Financial Planners: Do They Need Greater Regulation?" *Barrons*, March 11, 1985.

Competition's Impact on Rates and Availability

Some industry observers argue that competition is what undid the property and casualty industry in the early 1980's. At that time, they say, interest income on investments was in the double-digit range and competition for resources to invest was intense. To attract customers and funds, critics contend, some property and casualty insurers reduced their premium rates for commercial coverage. High rates of return on investments compensated for any losses sustained on their payouts on new policies.

But during 1985 and 1986, as interest rates fell, companies reevaluated their underwriting practices. Some refused coverage to high-risk clients and made increases in the rates charged to those clients they continued to cover. Predictably, cries of pain and outrage arose from those individuals, businesses, municipalities and services affected. But some property and casualty insurers and businesses pointed to the rise in liability litigation and to the evolving status of the civil justice system represented by state-level changes in tort liability. Insurers pointed out that large increases in the number of claims litigated, as well as the escalating size of awards made by courts, had to be dealt with in setting prices for liability coverage.[6]

The Push for Tort Reform

There has been a flurry of activity at the state level supported by the business community and insurers. And during the past few years, varying levels of tort-reform legislation have been passed in an about 40 states. The Administration introduced a package of three federal tort-reform bills in Spring, 1986, but these were not passed in the 99th Congress. Members of the House and Senate also introduced a variety of bills, including one that would establish a Federal Insurance Commission, but no action was taken.

Observers inside and outside the insurance industry point out that the liability crisis has activated industry opponents who wish to charge insurers with using the "tort reform" issue to camouflage the industry's cyclical problems. To some extent, this wave of opposition has helped to fuel new legislative proposals in the 100th Congress to review the antitrust provision of McCarran-Ferguson. Not surprisingly, more than half of the insurance companies participating in this study report they are active in coalitions that address the McCarran-Ferguson issue (Table 1).

During 1987, the 100th Congress began new hearings on tort reform, and new legislation has been introduced. Insurers are placed in a difficult political position because there is a possibility that amendments to a tort reform bill might carry with them greater federal oversight of insurance or modification of the McCarran-Ferguson Act. In the meantime, tort reform measures in some states may prove to be a mixed blessing for insurers. In a case currently in dispute, the State of Florida linked tort reform to industry pricing by passing a law which gives the state the authority to review commercial liability rates. Other states, such as Connecticut, are citing the failure of rates to decline following tort reforms as a rationale to rescind previously enacted reforms.

[6]See "Property and Casualty Executives Speak Out." *Best's Review*, June, 1986. For a further discussion of related issues, see also: Nathan Weber, *Product Liability: The Corporate Response*". The Conference Board, Report No. 893, 1987.

The Consumer: Still a Force

"The consumer ethic has been absorbed by the great mass of the American people," says First Interstate Bank of California's Vice President, Public Affairs. "Consumers are better able to articulate their demands, and expect fulfillment of promises and quality of service." Shawmut Bank's Vice President, Government Affairs remarks: "Today's consumer effort is more organized and sophisticated, but experience has also made us more sophisticated. It is already part of our business plan to address much of what they will come up with. They don't have to picket because they know that the communications lines are open—they can come in and talk to us."

In fact, many financial services executives note that it is good business to anticipate consumer demands. "It has become much more a marketing than a public-affairs issue," says Aetna's Vice President, Communications. "People talk about this business being 'market-driven.' Anyone who really means that will get out there and identify what customers want *before* they demand it." Executives at Sears' Dean Witter say this is just what they have done. "We generally start out with consumer research and try to meet a need before it becomes a consumer issue—we offer low-cost checking services at our savings banks and our credit card has no annual fee because consumers said that was more important to them than interest rates," says the company's government-affairs executive.

There is still some tension in the air, however. (See Table 3 for details on consumer issues on which financial services companies are lobbying.) In the insurance industry, consumer and other interest groups are challenging the fairness of the risk classification system used to establish the price of insurance premiums. Banks are being challenged on the level of interest rates on credit card balances and the limited availability of check-cashing and basic checking services to low-income individuals (such as the elderly or students).

Risk Classification: Insurers' Public Education Dilemma

A basic tenet of insurance is that the premium a customer must pay for coverage is determined by the risk he or she presents to the insurer. The insurance industry is discovering that the public does not always understand or approve of the use of risk classification to determine the price of its services. Two recent issues have demonstrated this. Both concern charges of civil-rights violations and discrimination—challenges that have come through the courts and in state legislatures. One controversy, apparently on the decline, is the issue of sex discrimination in insurance pricing, which has resulted in calls for "unisex pricing." The other, yet to be resolved, is the use of blood tests in determining eligibility for life or health insurance coverage. The specific focus of the dispute is whether insurers may test to determine the presence of antibodies to acquired immune deficiency syndrome (AIDS) in the blood of a prospective insuree.

Table 3: Consumer Issues: Direct Lobbying by Financial Services Companies[1]

Issue	Sector[2]	Federal Level: Number of Companies	Federal Level: Percent Lobbying Directly	State Level: Number of Companies	State Level: Percent Lobbying Directly
Risk Classification:					
Laws/Regulations requiring that insurance companies provide unisex coverage	I	26	70[a]%	26	75[a]%
Efforts to prevent use of special medical tests to determine risk of insuring potential customers (e.g., the AIDS antibody tests)	I	23	70	24	80
Laws/regulations to allow caps on health coverage for expensive medical procedures (e.g. dialysis, organ transplants)	I	24	20	22	45
Cost:					
Affordable banking services for low-income customers	B	20	50	25	70
Efforts to make insurance more widely available to low-income customers	I	22	20	26	40
Regulation/capping of credit-card interest charges	B	30	70	28	70
Closer alignment of bank charges for consumer credit, business loans and mortgage rates to interest paid to depositors	B	27	45	25	45
Repeal of anti-rebating laws	I	20	30	24	55
Disclosure:					
Increased disclosure/public posting/ explanation of bank fees, service charges and availability of funds to customers	B	27	50	26	50
Efforts for greater disclosure of prices/costs of insurance to consumers	I	22	20	26	40
Service:					
Establishing a standardized check-holding policy (to govern the period before funds are available to the depositor)	B	28	80	21	70
Calls for improved claims service	I	21	25	27	40

[1]See Table 1, note 1.
[2]Key: B = Banking; I = Insurance; S = Securities and Diversified Financial
[a] Percentages are rounded.

Unisex Coverage

Traditionally, women have paid lower prices for auto and life insurance because insurance data show that they have fewer accidents and live longer than men. However, insurers claim that women are more likely than men to make claims on their health and disability insurance policies (for example, due to pregnancy). Often, they are charged higher rates than are men for individual coverage of this type. Individuals and groups such as the National Organization for Women (NOW) have challenged this practice in the courts. There was a flurry of legislative activity related to the unisex coverage issue throughout 1984 and 1985. During that period, insurers mounted a vigorous state level effort to educate legislators and the public through media campaigns, direct lobbying, presentation of local workshops, and similar grass-roots efforts. Although a handful of states have legislation barring sex discrimination in setting rates for *auto* insurance, to date only one, Montana, has passed comprehensive legislation barring sex discrimination in setting rates for *all* lines of insurance.

AIDS: A Test

The unisex issue is not dead, but activity subsided in 1986, even as discussions over AIDS and insurance coverage heated up. Insurers contend that just as they use medical test data to assess their risk in insuring people with ailments like diabetes, cancer or heart disease, they must avail themselves of

test data that indicate whether a candidate has a high risk of developing AIDS.

Their critics contend that use of the AIDS antibody test is unfairly discriminatory and in conflict with basic individual human rights. Not only might a positive test result mean that an insurance candidate is rejected, but results could be passed on to others, such as employers, and become the basis for other forms of discrimination. Moreover, since large proportions of AIDS victims are male homosexuals, gay-activist groups have accused the insurance industry of discriminatory practices other than requiring the antibody test. They allege that insurers or their investigators have used home zip-code data and other methods to "weed out" male insurance applicants whom they suspected of being homosexual and thus at high risk of contracting AIDS.

Recently, legislative hearings over the AIDS antibody testing issue have been held at the federal level and in a number of states. Wisconsin, California and Washington, D.C. have passed laws restricting the use of the AIDS antibody test to screen prospective policyholders. Several other states have developed guidelines for insurers. Late in 1986, state insurance commissioners, working through the National Association of Insurance Commissioners (NAIC) adopted a set of model regulatory guidelines. Developed by members of the insurance industry, gay-activist groups, and state regulators, the guidelines address the issue of discrimination but stop short of taking a position on AIDS antibody testing. Among other things, the guidelines would bar insurers from asking direct or indirect questions about a policy-applicant's sexual orientation and require that investigators be instructed to refrain from doing so. Insurers would be permitted to ask candidates about the results of a prior test for AIDS antibodies, so long as the state allowed such testing.

In the meantime, a recent opinion poll by the ACLI revealed that only 35 percent of the public supported the use of risk classification by insurers, compared with 57 percent in 1979. The trade group is launching a 1987 print and TV advertising campaign to give consumers a better understanding of the principle of risk classification and how it is used in the underwriting process.[1]

Service: Why Does It Cost So Much?

Currently, bank services, especially the rates charged for credit cards, appear to be a prime target for consumer activists. For insurance companies, the key issue on the cost and service front has been property and casualty coverage, but as that crisis wanes, questions about pricing are surfacing at the state level.

1987: The Year for a Credit-Card Showdown?

Since the deregulation of the deposit side of banking in the early 1980's, banks have had to compete for funds. While the rate of inflation remained high, the interest rates banks offered on some kinds of deposits kept pace, but so did the interest rates they charged customers for credit cards and loans. With lower inflation by the mid-1980's, the rates on deposits dropped, but interest charges for loans and credit cards declined more slowly—in fact credit-card rates remained around 18 percent.

During 1986, the credit-card issue simmered at the state level, although only seven states actually passed legislation placing some kind of cap on the amount banks might charge. Connecticut, for example, capped the rate at 15 percent. Discussions have also taken place at the federal level, and early in 1987, new legislation calling for greater disclosure of card terms and the application of a floating cap to the rates was introduced in the 100th Congress.

Consumer groups have inaugurated their 1987 lobbying campaign with news conferences in six cities, calling for action by consumers: to discard credit cards from banks which charge high interest and apply for new cards at those banks which charge lower rates. Although banks admit that a lower rate of inflation has decreased their cost of funds, they contend that this is only one factor they must weigh in establishing interest rates for credit cards. Other factors include the costs of processing millions of small transactions and losses due to credit-card fraud. They argue that the credit-card issue has been manufactured by consumer groups. "Congressmen do not report receiving many letters on this issue from constituents. In fact in periods before key testimony on the issue, the number has been zero", says the government-affairs executive of a major bank.

Industry observers note that past studies show that customers do not seem to know what rates they are paying, but this may be about to change. As the 1986 Tax Reform Act phases out tax deductions for credit-card interest and lower interest-rate options become more plentiful, banks may have to compete or be left behind. New competition in bank credit cards may intensify the debate. In March, 1987, American Express announced plans to offer an "Optima" card to selected customers. Like the bank credit cards, Optima will offer revolving credit, but at a rate of 13.5 percent on outstanding balances. Sears also entered the credit-card fray about two years ago with its "Discover" card, pitched toward its middle-income customer base. Although the card's interest rate is above that of many bank credit cards, there is no annual fee.

Basic Banking Services

"Lifeline banking" is a term that makes bankers grimace, but the issue is one that continues to receive attention from legislators and regulators. Before deregulation, charges for checking accounts or check-cashing privileges were minimal. With competition, bankers say, their costs increased and they had to charge more for basic services. Sometimes the service fees were steep, more than low-income customers could afford. Consumer advocates contend that banks have cut the "lifeline" of such groups as poor elderly people who have no place to cash their Social Security check or store the funds they will use to pay their bills. In early exchanges, banking executives pointed out that other check-cashing services existed, that

[1]News "Ad Campaign Will Focus on Risk Classification, *Best's Review* (Life and Health Edition), December, 1986.

postal money orders could be used to pay bills, and that banks were in the business of offering services, not entitlements.

As the discussion evolved, some banks realized that the "lifeline" issue was developing broader connotations—critics were asking questions about banking's "public trust." A number of banks have developed a package of basic banking services, which may include checking with minimal fees (but paying no interest) or no-fee checking with a limited number of deposits or checks (combined with some other basic services such as check-cashing privileges and availability of money orders or cashiers' checks.) In 1986, the Federal Reserve developed a set of recommendations for basic banking. The guidelines must go through several additional approval levels, and compliance will be voluntary. Nevertheless, they are expected to have clout among the state-chartered banks regulated by the Fed. Bankers generally oppose regulation in this area; about half of the banks participating in this survey report lobbying on this issue at state and federal levels. Just under a quarter say they have a service for low-income customers.

Insurance Pricing and Anti-Rebating Laws

Another cost issue has attracted lobbying attention from insurance companies that do business in states such as California and Florida, where anti-rebating laws are under challenge. In effect, anti-rebating laws forbid insurance agents to lower the price they charge certain customers for insurance coverage through "rebating," or passing on part of their sales commission to a customer. Anti-rebating laws were passed in many states early in the 1900's at a time when intense competition among agents resulted in unethical sales practices and outright fraud. Those who support attempts to do away with these laws believe that healthy competition among agents will decrease the cost of insurance. Those who oppose repeal of the laws argue that they continue to protect consumers from the unscrupulous practices that were prevalent at the turn of the century. Industry observers believe that insurers may face challenges on the anti-rebating issue in additional states, as consumer groups put more pressure on companies to lower prices.

Adequate Disclosure and Service

Calls for more complete disclosure of service-initiation charges, fees, interest rates, and other information have created issues for both banking and insurance companies. Consumer groups are charging that banks do not make sufficient information available about account features such as deposit and loan rates, interest-charge calculations, and opening and minimum check balances so that customers can "comparison shop" among banks. Many banks say that they have increased their disclosure: "On the one hand, consumer groups tell us there should be more disclosure—on the other hand, they tell us that there is so much advertising that it is confusing," says one government-affairs executive. Regulatory agencies say that they are studying bank advertising and disclosure practices, using an interagency working group convened by the Federal Reserve Board.

Disclosure is not as strong an issue for insurance companies today as it was a few years ago, when the NAIC developed model regulations. Critics of the industry say it is still very difficult for consumers to compare policies and that NAIC guidelines recommended for life insurance in 1976 and revised in 1983 constitute "pseudo disclosure."[8] As with banking executives, many in insurance say that this is an issue generated by consumer activists, with very little grass-roots backing.

Adequate service is a perennial consumer concern. The key current issue is the question of how long banks take to clear a check and make funds available. Consumer groups say that banks delay payment well beyond the period it takes to clear a check and that it is often difficult for customers to get information about a bank's policy on check clearance and "funds availability." Federal regulatory agencies say that current laws are adequate to address this problem, but that they are studying ways in which the current check-clearing system might be simplified. Banking legislation currently before the 100th Congress contains a provision on this issue. (See page 5.)

The State Level: Insurer Insolvency and Bank Expansion

In the banking industry, issues of risk-based capital and deposit-insurance premiums have sparked controversy at the federal level. Insurers face similar challenges at the state level. In question are the level of reserves that should be set aside to cover losses and what mechanism (if any) should be used to engage solvent insurers in rescuing customers of an insolvent insurance company. As state regulators wrestle with insurance problems, banks have offered new challenges to state legislatures and the courts. While Federal legislation that would allow banks to expand nationwide has been stalemated in Congress, there has been no lack of activity at the state level.

Risk and Insolvency in the Insurance Industry

The year 1985 was a bad one for property and casualty insurers, who reported $5.6 billion in losses. Since early 1986, a number of insurers have raised property and casualty reserves to cover higher-than-expected future losses. Industry sources say that many of these losses may result from higher costs associated with increased tort activity. Late in 1986, the state of Texas reported that the number of insurance firms in receivership there had more than doubled in five years. Many of them were property and casualty insurers. Regulators in some states began to raise questions about the adequacy of insurers' loss reserves.

What happens to the customer's investment when an insurance company goes bankrupt? During the consumer movement of the early 1970's, state insurance commissioners, working through the NAIC, held that other insurers in the bankrupt company's state of "domicile" should be responsible. Some states formed guarantee associations through which insurers were assessed a set percentage of premium each year

[8]See J.M. Belth, "The Continuing Plight of the Consumer." *Best's Review* (Life and Health Edition), August, 1985.

until the bankrupt insurance company's obligations to its customers had been met.

By the mid 1980's, a large bankruptcy (Baldwin United Corporation) and several other failures led some insurers to question the guaranty association procedures. One concern: Would solvent insurers be required to guarantee customers of an insolvent company the same above-market rates of return—rates which had contributed to the bankrupt company's downfall? Fears of crisis brought on by new insolvencies and escalating demands helped stimulate thinking among insurers and their regulators.

Working with consumer groups and the insurance industry, the NAIC devised a new Guarantee Association Model Act. Among its innovations is one making each state's guarantee association responsible for covering only *residents* in its own state. If a sufficient number of states adopt the legislation, this would spread the burden for the bailout, rather than placing it exclusively on companies in the state where the failed company legally resides. States without guaranty associations are being urged to review the model act for possible adoption; some states with guaranty associations may review the model and amend their current laws.

States' Rights and the National Banking Imbroglio

"Markets without products and products without markets make no sense," says the government-affairs executive of a large eastern bank. "We will continue to push for national banking and a full range of products or we can't compete." Federal laws permit a state to authorize the entry of out-of-state banks, so long as it enacts specific legislation to that effect. In the early 1980's, groups of banks in geographic regions around the country (usually contiguous states) helped develop the concept of regional banking "compacts." In effect, an individual state passes a law that allows banks from other specified states to make acquisitions within its borders, provided these states reciprocate. Other states in the region pass similar laws.

The compacts sometimes bar large banks from money centers such as New York and Chicago from acquiring banks in that state. This tactic reflects local concern that large, out-of-region banks might, through acquisition, become the dominant force in the "territory." In many cases, it was the larger, regional banks in each area that led the campaign. Smaller, community banks went along on the theory that a regional compact was better than full interstate banking.[9]

Regional Banking Compacts

New York banks seemed to be excluded most often from the compacts, and several, including New York's Citicorp, decided to test the legality of the compact in New England. An appeal to the Federal Reserve ended with the Fed supporting the compact; a U.S. Court of Appeals in New York upheld the Fed's decision. The case was then appealed to the Supreme Court, which upheld the lower Court's decision (Northeast Bancorp v. Board of Governors) in June, 1985.

National banking legislation under consideration at that time would have permitted a five-year grace period before full national banking went into effect. This would allow time for banks to consolidate on a regional level before the huge outsiders could invade. But the Supreme Court decision made it unnecessary to provide this safeguard—the compact approach had already solved the problem. In the view of many medium-sized and small banks, national legislation was now not only unnecessary but even unwanted.

While national banking may be in limbo at the federal level, interstate and regional efforts proceed apace. More than 35 states allow banks from some other state or states to make acquisitions in their jurisdiction. A few states, including New York, Maine, South Dakota and Arizona, have laws that allow banks from any state to enter. (New York requires reciprocity; the others do not). California and Texas passed laws in 1986: California's allows entry by nonregional banks by 1990, but the Texas law had more immediate applicability. Late in 1986, Chemical New York Corporation became the first major bank to take the plunge by announcing a planned takeover of Houston's Texas Commerce Bankshares.

In the meantime, some banks have managed to expand geographically through "special-case" acquisitions of failed banks or thrifts. (See Box.) Bank regulators are seeking powers that would let banks acquire failing as well as failed institutions, and their holding companies. If the Comptroller of the Currency is again empowered to issue nonbank-bank charters, these will also be an avenue to geographic expansion. (See page 7.) Among the banking companies participating in this study, more than half have been actively lobbying on this issue at the state level (Table 1).

Many observers contend that the regional-compact era is transitional and point to the emergence of "super-regional" banks as one of the positive outcomes. These institutions—like First Union, NCNB and SunTrust in the Southeast, Banc One in Ohio, and Boston-based Bank of New England—have grown in asset size and capacity through mergers. A recent article noted that "super regionals" are less likely to be saddled with the third-world loan problems that have plagued the money-center banks; they are believed to be in a better position to tap consumer and middle-market corporate business. As such banks grow in size and sophistication, there is even some speculation that they foreshadow the demise of the money-center bank.[10] Yet the pace of competition, along with product and service innovation by major banks, continues to escalate. Although there are confident predictions within the industry that national banking will become a reality during the 1990's, as yet few observers seem to be placing firm bets on the topography of the new banking landscape.

[9]Arizona may be an exception. According to press reports, small bankers in that state lobbied for national banking, hoping to get "the broadest possible market for their stocks". See Robert Bennett, "Interstate Banking's Difficult Birth." *The New York Times,* June 2, 1985.

[10]"Banking's Balance of Power is Tilting Toward Regionals." *Business Week,* April 7, 1986.

Focus on the Future

Whether the financial system is restructured quickly or evolves more slowly, businesses and consumers will see significant differences in the way they purchase and receive financial services. And the companies that provide these services will be under increasing pressure. Some of the hurdles that these firms, their regulators and legislators may have to overcome include:

• *Securities* firms must restore their industry's credibility in the wake of the insider-trading scandal. Companies may be able to satisfy their critics that they can reinforce the "Chinese Wall" that has traditionally separated investment banking and arbitrage. But some observers believe that stiffer regulation or new legislation will be required.

• Major *banks* have been in the forefront of the battle for deregulation. Will the banking industry be restructured and more completely deregulated?

— As commercial banks expand into markets formerly reserved for investment bankers and insurers, there are many questions about how to safeguard the safety and soundness of the banking system. Beyond issues of what will be permitted are decisions about what organizational structure would work best.

— Do bankers have an alternative to deregulation? Observers suggest that one or more major firms might challenge the system by dropping its federal charter and reorganizing, perhaps as a diversified financial services company.

— Some industry observers note that deregulation in the early 1980's removed so many of the barriers distinguishing thrifts from commercial banks that it no longer makes sense to divide the two. They wonder whether thrift institutions should continue to have a separate depository-insurance agency.

— A new wave of pressure on consumer issues may be in bankers' future. The Chairman of the Senate Banking Committee in the 100th Congress is reputed to be more consumer-oriented than his predecessor.

• *Insurers* seem likely to be challenged at both the state and federal level. Smaller firms are opposed to federal regulation of insurance, but larger companies that have diversified from an insurance base see possible advantages. Executives point out that federal bank regulators often speak out to defend that industry, but insurers have no such champion. Moreover, some diversified firms find state regulation of their insurance activities increasingly cumbersome.

— Questions about the fairness of insurance pricing, the industry's system for compensating insurance agents, and how industry competition affects the consumer will continue to challenge insurers.

The Versatile Thrift Institution

The "thrift" industry, which is made up of savings-and-loan institutions as well as mutual savings banks, is currently experiencing the best and worst of times.[1] While stories of failing thrifts and the depleted funds of the FSLIC continue to make headlines, probably as many as three-quarters of the nation's thrifts are solvent.[2] Many are quite profitable. Since their basic business is home mortgages and mortgage interest rates are fairly low, their business is booming as consumers buy homes or refinance their existing mortgages. This has made the thrift industry more attractive to commercial banks. Some, like New York's Citicorp, have purchased failed thrifts in California, Florida and Illinois, states where they are prohibited from acquiring commercial banks. Early in 1987, Citicorp also agreed to acquire 50 savings and loan branches in Southern California from Sears, when Sears decided to concentrate thrift activity in its stores.

More recently, other commercial banks have been trying to acquire healthy thrifts, with plans to convert them to full-service banks. Since that would take away healthy members of the beleagured FSLIC insurance fund, regulators are reported to be looking for ways to avert such moves.

Still other thrift institutions are taking advantage of a new wave of investor interest by converting from mutual to stock companies. In some cases, stock is sold to the broad public; in other cases, it is purchased by a small group of investors. Some observers question whether the change in control will alter the basic mission of savings institutions—that of the "neighborhood-oriented housing lender."[3]

Thrifts have also set up shop in Sears and K-mart stores. Sears owns its thrifts, but K-mart has made a deal with a unit of Ford Motor Company. Ford's First Nationwide Bank (the country's 7th largest thrift) will set up kiosks in 150 K-mart stores during 1987. Among the services available at retail-store thrifts are home loans, Certificates of Deposit, charge cards, and routine checking or savings accounts.[4]

[1]Technically, the term "thrift" also includes credit unions and industrial banks.

[2]In the current Congressional debate over the amount to be set aside for recapitalization of the FSLIC, thrift-industry executives are divided. Some believe that too large an infusion of funds may tempt regulators to liquidate troubled institutions in lieu of helping them achieve a profit turnaround. Others believe that that a significant infusion of funds will help restore public confidence in the industry and ensure its long-term survival.

[3]See Eric Berg, "State Savings Banks Thriving," *The New York Times*, February 7,1987.

[4]See "Attention Savers! K-mart Wants You," *Business Week*, January 19, 1987.

— Life and health insurers will be struggling to find constructive solutions to the dilemma of insurance coverage for potential victims of AIDS. Executives must find ways to protect their companies' profitability without provoking public accusations that they are insensitive.

— Property and casualty insurers will reap benefits from tort reform, but continued activity may bring higher costs as well.

• If they hope to participate in "banking" activities, *commercial firms* that diversify into financial services face a stiff challenge. They must convince legislators and regulators that there is a way to meld banking and commerce without serious threat to the nation's depository system.

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- *growing phenomenon fraught with risk*
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- *U.S. venture capital investments now total $22 billion*
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Research Bulletin No. 214

Sources of Information

Much of the information for this survey came from the written responses of 154 senior officials of large, and for the most part, publicly owned corporations around the globe. Additional data was obtained through interviews with survey respondents and other knowledgeable executives.

Table 1 classifies 154 responding firms by geographic area and shows the percent of those involved in business venturing. Survey results demonstrate that levels of participation are virtually the same in the United States and in Europe. Of the 98 venturers there are 63 manufacturers, 24 financial service institutions, five utility or telecommunications firms, three retail firms, two transportation companies, and one mining company.

Table 1: The Venture Postures of 154 Surveyed Companies

Domicile	*Number of Respondents*	*Venture Participation Yes*	*No*	*Percent Involved in Venturing*
United States	103	67	36	65%
Europe	41	27	14	66
Great Britain	13	8	5	
Germany	9	7	2	
Switzerland	6	4	2	
Holland	3	2	1	
France	2	2	0	
Italy	2	1	1	
Finland	2	2	0	
Sweden	2	0	2	
Belgium	1	0	1	
Norway	1	1	0	
Elsewhere	10	4	6	40
Japan	6	2	4	
Australia	2	1	1	
Taiwan	1	0	1	
Israel	1	1	0	
Total	154	98	56	64%

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Corporate Venturing

by Patrick J. Davey

Introduction

To venture is to embark on a project fraught with peril. In this broad sense, virtually all company undertakings are venturesome; but some clearly entail more than ordinary business risk. It is those involving extraordinary risk that constitute corporate venturing. Many major companies pursue venture strategies, despite historically high failure rates and long waits for returns from successful projects. What do they hope to accomplish? How successful are their efforts? The purpose of this report is to answer these and related questions by exploring the experience of corporate venturers, as well as the attitude of companies that have shunned or abandoned venturing.

Corporate venturing takes many forms: vigorous pursuit of internal R&D, cooperative R&D efforts, new product development programs, licensing, acquisitions, and investments in emerging businesses.[1] This report focuses on corporate sponsorship of small companies; it also examines corporate experience with internal new business programs and other venturing vehicles.

The emergence of U.S. corporations as venturers in this sense is fairly recent. Prior to the end of World War II, much venture capital represented commitments by wealthy families in support of entrepreneurs whose proposals appealed to them. In the 1950's and 1960's public and private venture capital organizations, including Small Business Investment Companies (SBICs)[2] and corporations, began to appear in increasing numbers as suppliers of venture capital. The U.S. venture capital industry today encompasses private partnerships, investment banking affiliates, SBICs, financial institutions, such as banks and insurance companies, and industrial corporations. A somewhat more restricted community of venture investors, including a growing number of corporations, exists abroad, especially in Great Britain and the rest of Europe.

Domestic venture capital investments about tripled over the past several years and are now estimated to total $22 billion.[3] Perhaps one-fifth of that amount represents commitments of industrial corporations and financial institutions.

Major Findings

Corporations venture primarily to secure *attractive returns*, access to *technological developments, growth and diversification*, and improvements in *employee morale*. For the most part, they are reasonably satisfied with the results of their efforts; but some have experienced dissapointment. Study participants that abstain from venturing indicate that it conflicts with strategic plans, offers insufficient financial inducement, or poses legal problems.

Believing that flexibility is essential to success, the companies surveyed typically use two or more venture investment approaches. Some set up internal groups to develop, invest in, and manage new businesses that have special growth appeal. Others take minority equity positions in small companies that have developed advanced technologies or hold other attractions. Still others participate in strategic alliances and spin-offs. And a number invest in independent venture capital partnerships, directly or through their pension funds.

Companies that prefer passive roles turn to external managers, ordinarily partners of independent funds, to oversee their venture investments. Other sponsors, especially those wanting to maintain very close relationships with the companies in which they invest, manage venture programs themselves. Some use external managers initially but switch to in-house administration later on.

Corporate venture managers often enjoy prestigious positions in the corporate hierarchy. They frequently report to senior officers and even, in a few instances, directly to the board of directors. A minority of study participants provide special incentive compensation programs for internal managers.

[1] See, for discussion of some of these approaches, James K. Brown and Lita M. Elvers (eds.), *Research & Development: Key Issues for Management*. The Conference Board, 1983, Report No. 842; Allen R. Janger, *Organization of International Joint Ventures*. The Conference Board, 1980, Report No. 787; James K. Brown and Lillian W. Kay (eds.), *Corporate R&D Strategy, Innovation and Funding Issues*. The Conference Board, 1985, Report No. 863; James K. Brown, *Refocusing the Company's Business*. The Conference Board, 1985, Report No. 873; James K. Brown and Lillian W. Kay (eds.), *Tough Challenges for R&D Management*. The Conference Board, 1987, Report No. 895.

[2] Small Business Investment Companies (SBICs) are licensed by the Small Business Administration of the federal government. They are an important source of financing for small businesses. For an explanation of the role of SBICs, see J. Fred Weston and Eugene F. Brigham, *Managerial Finance*. Hinsdale, Illinois: The Dryden Press, 7th Edition, 1981, pp. 993-995.

[3] Stanley E. Pratt and Jane K. Morris (eds.), *Guide to Venture Capital Sources* (Eleventh Edition). Wellesley Hills, Massachusetts, Venture Economics, 1987, p. 8.

Why Venture?

Companies venture either for strategic or financial reasons or for both. Often they desire to develop emerging businesses while realizing returns sufficient to compensate for the risks assumed. The objectives targeted by participating companies for their venture programs are presented in Table 2.

In several surveyed companies, venture goals were either changed entirely or underwent a switch in emphasis. For instance, some venturers reported that programs originally geared to developing scientific know-how are now aimed at realizing high rates of return. This demonstrates that, over time, they have come to regard their venture activities more as profit centers than as sources of technology.

Attractive Return on Investment

Studies reveal that the prospects for small emerging companies are limited. A 1982 study conducted among corporate sponsors, for example, found that 30 percent of all venture companies failed within two years of inception; another 30 percent suffered a similar fate thereafter. Only 40 percent of venture investments proved viable, of which three-quarters did reasonably well and one-quarter very well.[4]

Six venturers in the current survey report that they seek an average rate of return ranging from 15 percent to 70 percent; the median targeted return is 25 percent. Of course, to achieve such high returns, companies must establish much higher hurdles for individual undertakings to compensate for both unsuccessful investments and the lengthy period—five to ten years—typically required to liquidate or otherwise realize gains on profitable ventures. Explains the Executive Vice President of a U.S. financial institution's venture arm that requires a 25 percent rate of return for its entire portfolio: "Due to some companies becoming defunct, a minimum investment hurdle of 40 percent per year is required. For seed capital investing (prior to prototype development), the hurdle may be as high as 100 percent per year."

Window on Technology

The acquisition or transfer of technology is an important goal of many corporate venture programs. Through various kinds of cooperative arrangements, corporations hope to share in the benefits of the technological breakthroughs achieved by the entrepreneurial companies in which they have invested. (Noteworthy scientific accomplishments by small companies—as, for example, in the electronic and biotechnology industries—have contributed in significant ways to their sponsoring companies.) An official of a U.S. consumer products firm seeking technological support through venturing comments:

> "Recently, we have made investments in two small computer technology companies. We believe each company is on the leading edge of its area of expertise. Therefore, the purpose of these investments is to make sure that we stay abreast of their development work and provide a stable base of financing and management advice while their work continues. The investments were not, in other words, motivated by the prospect of financial gain, although we believe both companies will achieve a measure of financial success if properly supported.
>
> "We are also considering an investment in the biotechnology area and a number of potential companies are under review. Here again, our motivation is to extend our research and development effort in areas of strategic interest and is not prompted by the desire for direct financial gain."

Table 2: Venture Objectives in 98 Companies

Objective	*Number of Mentions*
Attractive return on investment	42
Window on technology	32
Growth and diversification	30
Enhancement of entrepreneurial spirit	13
Other	9
Total	126

Growth and Diversification

Faced with poor or uncertain prospects in existing businesses, many companies turn to venture activities to enlarge their interests, and their goals are not always modest. One queried firm, maintaining that corporate renewal holds the key to survival, launched a new business development effort heavily dependent on venturing; it is targeted to add $500 million to total corporate sales over a ten-year period.

The primary route to growth and diversification is acquisition, which venturing fosters. Venture investors often expand small initial investments in entrepreneurial companies to assume controlling interest—moves that enable venturers to achieve desired sales and restructuring objectives.

Enhancement of Entrepreneurial Spirit

"One of the major corporate initiatives is to foster and stimulate entrepreneurship in all phases of our business," says the Vice President, New Business of a U.S. company that has opted for venturing. Others, believing their firms are shackled by bureaucratic rules, view venturing as a means of instilling a more daring spirit in their organizations.

Other Goals

Marketing and training assistance are also cited as venture objectives. A utility company, for example, expects its commitment to venturing to contribute to the economic development of its service area and ultimately to its volume. A food company finds venturing a useful tool in management development. Its Director of Product Improvement states:

> "We see venturing as an important and viable way of developing general managers or people for other key managerial positions. Working as leader of a venture gives individuals the

[4]Richard P. Greenthal and John A. Larson, "Venturing Into Venture Capital." *Business Horizons*, September-October, 1982.

opportunity seldom available in other parts of the corporation to work with all aspects of a business. Additionally, we realize that many of our employees have excellent ideas that never surface under our existing structure. Helping them develop these ideas not only helps the corporation but also helps the individual develop in a self-fulfilling and meaningful way."

Venturing Is Not for Everyone

Fifty-six of the 154 surveyed companies do not sponsor emerging businesses at the present time; but ten of them—eight domestic and two foreign companies—are investigating the possibilities. Among the reasons respondents offer for not venturing:

- *It conflicts with the long-term plan.* "While we do continually evaluate merger and acquisition opportunities, the targets are generally proven firms in established industries. Investing in seed companies in emerging industries does not fit with our strategic plan," comments the Vice President and Controller of a U.S. transportation company.
- *It is not financially attractive.* Financial rewards from venturing, though attractive on a relative scale, may not appear substantial on an absolute basis, at least in the near-to-medium term, to companies whose earnings already amount to hundreds of millions or even billions of dollars.
- *It is not needed.* A few firms, pleased with their own internal R&D and new product development efforts, find it unnecessary to look to outside sources for growth. They prefer to rely on their own abilities.

Six of the fifty-six firms that currently do not sponsor corporate ventures are former venturers. The Director, Mergers and Acquisitions, of a participating U.S. chemical company, offers the following reasons for the changeover, echoed in whole or in part by others who have gone the same route:

> "Executive management felt it was unlikely that a venture capital investment could have a significant impact on the bottom line of a company of our size;
>
> "The general state of the venture capital industry was poor in the early and mid 1970's. On the other hand, there were significant demands for capital in the core business of the parent so it was difficult to compete for capital;
>
> "Although the venture capital group was organized as a separate entity, the structure of its board and authorization policy resulted in the operating management of the parent corporation having a strong influence on the investment decisions;
>
> "The preponderance of opportunities available for venturing were in electronics, telecommunications, software development, and medical device development. These areas did not fit our stated corporate strategy and therefore limited the chances of our finding a 'window on technology' related to our strategy; and
>
> "Our experience showed that a corporate venturer was more vulnerable to legal action by other shareholders due to the 'deep pockets' view of a corporate venturer vs. a more conventional venture fund."

Table 3: Sources of Ideas for Venture Capital Projects

Source	Number of Mentions by U.S. Firms	Number of Mentions by All Other Firms	Total
Internal functions	32	11	43
External organizations	23	2	25
Outside professionals	6	-	6
Other	14	6	20
Total	75	19	94

Total number of firms answering this question: 45

Preparing for Venturing

After studying the pros and cons, companies that decide to pursue venture capital investments launch preparatory efforts. Initially, these focus on the generation of project ideas and the establishment of investment guidelines.

Generation of Investment Proposals

A steady stream of investment ideas is essential to the success of corporate venture programs, especially since relatively few are usually able to withstand the winnowing process. Table 3 indicates the sources from which 45 companies obtain recommendations on venture capital projects. What respondents stress, however, is that venture ideas can and do originate virtually anywhere.

Surveyed companies put suggestions from R&D and planning at the top of the list; marketing, development, manufacturing, financial and legal functions are cited as well. "Venture ideas nearly always originate in the groups and staffs as they seek to meet their objectives; however, input from management, corporate planning, treasury, legal, etc., is regularly obtained," notes a Senior Vice President of a U.S. manufacturing company. The branch networks of participating banks are also fertile ground, as the Managing Director of a British bank subsidiary notes: "The main source of introductions is the . . . branch network in the UK. Other sources are firms of professional advisers and other financial institutions such as syndicate partners."

Three study participants maintain task forces to identify possible venture situations. "Venture ideas can and do originate from all conceivable internal and external sources. The majority, however, are identified by a new venture group whose primary function is to do just that. The one source we have found to be uniquely infertile as a source of new business ideas is the venture capital community," comments the Chief Financial Officer of a U.S. manufacturing company.

Of course, this approach is not shared by all, and the venture capital community is often cited by other firms as an external source of venture ideas. As the President of a U.S. venture subsidiary remarks, "Our investment opportunities are generated through relationships with other venture capital groups, as well as lawyers and other professionals who represent entrepreneurs putting together start-up ventures . . . We have also developed relationships with a number of leading scien-

Sample Investment Guidelines

"Venture investments are made on the basis of a potential long-term strategic fit, a fit with existing capabilities and experience, the potential for significant revenue and earnings, and the potential for superior financial returns. To minimize charter overlap and to maximize autonomy, internal ventures also must serve a market segment not currently served by an existing organization and cannot rely on corporate marketing or manufacturing resources for their success; in turn, a venture's success cannot be key to corporate strategy. In addition, internal ventures must meet venture capital-like hurdle rates and are limited to a small up-front investment."

Diversified U.S. manufacturing company

* * *

"Our basic guidelines concern investment in situations where (i) proprietary technology or ideas exist; (ii) there is a basis for developing an enterprise that will have annual revenues of $30-$50 million in three to five years; and (iii) we expect a rate of return in excess of 40 percent compounded per annum."

Venture subsidiary, international mining company

* * *

"The subsidiary seeks companies with a solid understanding of their business and their markets. Proprietary product advantage and commercial promise are key factors, but management quality is the overriding consideration. We firmly believe that the eventual success of any start-up company is the direct result of management expertise, commitment, resourcefulness and tenacity.

"Our paramount concern is to meet the financial and strategic objectives of our investors. Investing in companies likely to achieve a successful start-up best meets those concerns. The subsidiary adds value to the portfolio companies by fostering a climate wherein company management and interested investors can rationally assess the likelihood of successful business alliances of benefit to all parties.

"We are interested in such fields as semiconductor fabrication support systems, electronic testing equipment, telecommunications, defense electronics, data communications, bioengineering/medical diagnostics, health care products and services, specialty semiconductors, graphics, fiber and electro-optics, artificial intelligence, computer aided engineering, technical data processing, advanced materials, specialty chemicals, etc.

"We support every investment decision with extensive field research, drawing upon experience available with the parent as well as that of independent consultants. And we share with other investors our analysis of the company, its technologies and markets, when appropriate. The subsidiary seeks investments primarily in the start-up and early stage of new enterprise development, including seed financing, in which we work with entrepreneurs to develop business plans. We also consider appropriate mezzanine financings and management buyouts. Our investments range in size from $500,000 to $1.5 million and generally include a commitment to provide follow-on financing. Our investments involve a meaningful minority equity position for the subsidiary, although in selected situations we also consider debt or convertible debt instruments.

"We are prepared to be the lead investor or to co-invest with other committed venture capitalists. We work with a group of highly successful venture capital firms and investment bankers on both the East and West Coasts, as well as in Japan, Hong Kong, Singapore and Europe.

"During their four- to eight-year development time frame, we anticipate that most of our portfolio companies will go public or will merge with other companies, including possible alliances or mergers with some of our limited partners. At all times, we encourage management to pursue a business strategy that is most beneficial to the company and lend our support accordingly.

"We contribute to the venture company's success by pledging our full range of business and technical expertise and resources and, when suitable, by serving on the company's board of directors."

Venture capital subsidiary, U.S. manufacturing company

tists who put us in touch with new investment opportunities that they become aware of."

Bankers, accountants, lawyers, consultants, and, of course, entrepreneurs were among the professionals reported by companies as outside sources of venture ideas. Other sources include university research programs, trade shows, and conferences.

Investment Guidelines

The ground rules for investment in venture capital projects established by participating companies range from broad to specific and may or may not include financial considerations. For example, a guideline might target technological advances or define the stages of a proposed investment (see box). Or, it might spell out detailed instructions for:

- *Desired Returns.* Investors may set average annual return objectives of 25 percent or more for funds placed in venture capital projects.
- *Constraints.* Some companies limit investment options. For example, companies may exclude investments in the manufacture of non-related products or in industries they consider subject to onerous regulation.
- *Location.* Venture sponsors sometimes restrict investments to a specific geographic area—often convenient to headquarters. Proximity is believed to facilitate monitoring in such cases.
- *Investment Preferences.* Preferred investment characteristics are often outlined.
- *Fields.* Genetic engineering or ceramics, for example, may be singled out as appropriate choices.
- *Size.* The amount of the investment may also be restricted. For instance, a company may set $500 thousand as a minimum and $5 million as a maximum commitment to any single venture. Type of financing is another investment feature regularly

A Contingent Investment Approach

One recently organized venture subsidiary of a U.S. manufacturing company has a three-part investment strategy. The firm initiated Stage I by investing a moderate portion of its available capital in several independent venture capital funds. This strategy is designed to provide access to attractive deals and technologies. Stage II calls for co-investing in independent partnerships to strengthen equity positions in certain preferred portfolio companies and to appraise the deals and the entrepreneurial enterprises. Stage III depends upon the success of the first two. If all goes well, the subsidiary will ultimately invest the profits realized from its earlier efforts directly in venture projects to achieve technological and financial advantages.

addressed. Sponsors may decide whether funds should be placed in early rather than later stages (see box).

- *Business Plans.* Of course, would-be investors in venture projects insist on reviewing business plans before furnishing financial or other support. The plans are expected to include: a history of progress to date, background information on management, and recent financial statements, as well as financial projections (e.g., balance sheets, profit and loss statements), product descriptions and marketing plans.
- *Other Policies.* The form and extent of holdings and of participation of officers or other company employees in venture organizations may be spelled out. For example, a sponsor may limit the percent of equity interest held in any venture and insist on board representation.

Ground rules are designed to fit the needs of individual companies and so vary considerably from one to another.See box for some representative investment guidelines.

Selecting Venture Capital Vehicles

After deciding to embark on a corporate venture, arranging for the submission of investment proposals, and setting out ground rules to guide their programs, companies must then choose from among a variety of investment vehicles.[1] Table 4 demonstrates that many of the 98 surveyed venturers opted for multiple approaches.

Types of Venture Financing

Broadly speaking there are four types of venture financing: early stage, expansion, rescue, and mezzanine. Early-stage financing includes seed financing used by entrepreneurs to develop business concepts and prepare business plans; start-up financing for product development; and first-stage financing to begin manufacturing.

Expansion financing, as the name implies, is used for building the business and may involve two or more stages. Funds invested at each of these stages provide the capital necessary to sustain increasing levels of business activity.

Rescue financing is sometimes furnished in attempts to reverse the fortunes of ailing firms. Such funds are advanced to support the efforts of management, often of new management.

Funds also serve as mezzanine financing for companies on the verge of making public offerings. (On occasion, venture investors even purchase interests in secondary markets or participate in leveraged buy-outs.)

Table 4: Venture Vehicles Employed by Participating Companies

Strategy	Number of Mentions by U.S. Firms	Number of Mentions by All Other Firms	Total
Proprietary corporate venturing programs	57	21	78
Venture capital partnership investments	29	19	48
Pension fund venture investments	14	-	14
Joint ventures and strategic alliances	14	10	24
Spin-offs	2	2	4
Other	9	2	11
Total	125	54	179

As a Vice President of a U.S. consumer products company succintly comments, "Clearly, we believe that flexibility in venturing is crucial. There is no one defined route to success. Having multiple options is a benefit."

This sentiment was seconded by an Executive Vice President of a U.S. manufacturing firm: "We utilize all of the different approaches because each has advantages for specific circumstances. For example, investing through venture capital partnerships provides us with a broad overview of new markets and technologies, coupled with attractive financial returns. Direct investments enable us to work more closely with smaller companies where the fit (with the company in terms of technology, markets, etc.) is especially close, and where we can add value in ways beyond merely providing capital. Internal ventures can commercialize internally developed technology and provide the closest linkage between our venturing activities and our present operations."

Proprietary Corporate Venture Programs

Seventy-eight participating companies established internal units—subsidiaries, departments, divisions, intrapreneurial groups (entrepreneurs operating within large corporations), SBICs (in the case of U.S. banks)—to handle a portion or all of their venturing activities. Venture subsidiaries often function in a manner that parallels the activities of their external counterparts, venture capital partnerships; that is, they screen investment prospects, commit funds, monitor developments, and arrange the liquidation of investments. Other internal corporate venture groups may focus not only on direct investments in emerging firms but also on lending them managerial support. Or, through intrapreneurial efforts within the corporation, venture units may concentrate on the development of entirely new businesses.

[1] For a detailed perspective on venturing strategies, see Edward B. Roberts, "New Ventures for Corporate Growth." *Harvard Business Review*, July-August, 1980, pp. 134-142.

Venture sponsors see special advantages in many vehicles, but most agree that they attempt to select the vehicle best suited to their own purpose. Suitable vehicles generally serve diverse functions. For example, companies with proprietary programs believe this approach encourages the formation of close working arrangements with sponsored companies, permits better control over investments, fosters entrepreneurial spirit in their organizations, presents more opportunities for synergy, and contributes to the enhancement of "shareholder values."

Venture Capital Partnership Investments

Forty-eight of the respondents invest in venture capital partnerships, through which they become limited partners in venture funds managed by outsiders. Some externally managed funds are custom designed to meet the special requirements of corporate investors. A participating food company, for example, instructed its external manager to invest its funds solely in emerging food-related companies. The manager, in turn, created a special fund to meet that requirement.

Individuals with strong educational backgrounds in finance or science often manage private venture capital partnerships. They also usually possess considerable hands-on experience acquired through prior associations with investment banking firms, sizable family investment groups, or corporate venturing units. As managers, they apply their expertise to screening investment possibilities, examining the business plans of fund-seeking entrepreneurs, arranging investments, and disposing of investments at opportune times. They also work with emerging companies as board members, strategists, counselors and critics; partners may even choose new management when necessary.

For their efforts, venture capital partners receive management fees and a share in the proceeds at the time of liquidation. Managers often reap sizable rewards from successful funds, but few complaints are heard from other investors, who also benefit.

Firms that rely on venture capital partnerships believe they offer several advantages. First and foremost, they provide an introduction to an unfamiliar but alluring field of investment and permit companies to focus their investments in desired industries. Moreover, ties to independent partnerships frequently ensure that capable, well-motivated management will be in place from the outset to watch over the fortunes of the emerging companies.

Using venture capital funds to manage venture investments sharply cuts back the amount of time senior corporate managers must devote to this activity. The reports of independent partners also help corporate investors keep track of the flow of deals and of developments that can turn seemingly attractive projects into bottomless pits for investment funds.

Venturing Through Pension Fund Investments

Fairly recent developments encouraged 14 U.S. survey participants, some with little interest in other forms of corporate venturing, to commit a portion of their pension funds to venture capital investments. An early impetus came from the 1979 Department of Labor ruling that pension fund investments in venture capital projects did not violate the "prudent-man" standard. More current inducements include the attractive returns realized by many venture capital funds, the increasing use of pension fund venture investments by peers, and solicitations by venture capital partnerships. While the percentage of pension assets an individual firm devotes to venturing is usually small, the total amount invested is substantial, because of the large number and enormous quantity of pension funds.

Companies frequently choose independent partnerships as vehicles for their pension fund ventures. This route offers diversification, professional management, and, sometimes, above-average returns—features prized by pension fund money managers. On occasion, however, firms use pension funds to make direct investments in emerging companies.

Strategic Alliances

Strategic alliances suggest different arrangements to different participants. To some they are simply joint investments by two or more investors in a new company tailored to achieve a particular objective—as, for example, creation of a television production company by a broadcaster and a movie maker. Strategic alliances may also occur when companies pool their resources to secure a desired end. A retailer, for example, may attempt to increase sales volume and to raise profitability by affiliating with a company that provides financial services, such as insurance or banking. To others strategic alliances are special partnerships between mature and emerging companies, in which the established firm not only takes a minority equity position in the smaller one but also negotiates an agreement with it. (Agreements may include provisions for marketing or for R&D, for example.)

Whatever the form, strategic alliances are designed to benefit participants by combining their individual strengths in a fruitful union. Technological developments, competitive pressures, and cost considerations are among the key factors that prompted 14 domestic and 10 foreign respondents to enter into such alliances. Explains the General Manager of a European retailing company: "We have taken this approach (rather than external capital investing through venture capital funds) in the belief that there are opportunities for technology transfer between the investment and several of our businesses; we will have access to new project ideas and wider intellectual resources; and we can provide marketing and international distribution opportunities for the investment's potential new products."

Spin-offs

Internal R&D efforts sometimes result in the development of a promising product or technology that for one reason or another does not complement existing product lines. Confronted with that dilemma, four respondents reported separating or spinning off the new activity as a distinct and autonomous enterprise.

The sponsoring company can participate in any success recorded by the new business through licensing or other arrangements and through partial ownership. In this way spin-offs

facilitate divestment without complete loss of financial participation. Moreover, former employees of the parent company, anxious to test their mettle as entrepreneurs, usually assume management roles in the emerging enterprise.

An official of a venture capital subsidiary of a German manufacturer describes how a spin-off evolved: "In the middle of 1984, a team that had been working in the field of X-ray measurement technologies started its own business, fully supported by the parent. The former employees have established their own company to develop, manufacture and sell test equipment for integrated circuits. The head of the team had for years been developing the relevant technical concepts and patents.

"From this work there emerged not only the desired test instruments for the parent's requirements but also marketable products. These, however, did not fit in with the parent's large volume product range. Its sales departments are mainly geared to a standardized products business and not to the sale of this kind of special equipment. So the idea was born to set up an independent company which would deal with this kind of business.

"In return for the free use of the preliminary work done by the parent as well as the latter's patents, the entrepreneurs have granted their former employer a share option in their new enterprise. Following the foundation of the new enterprise, a German venture capital corporation has bought an interest in this firm."[6]

The same German executive sees spin-offs as generally good corporate venture vehicles. In his view, they are an excellent means of developing entrepreneurial talents and of helping to overcome cultural norms that place higher value on job security than on "being one's own boss." The executive also cited another important by-product: the creation of employment opportunities.

Other Venture Forms

Other venture approaches occasionally mentioned by survey respondents include participation in university research programs and association with the scientific community. Contact with medical researchers prompted one company to organize and fund their work, which was considered promising. The company's ultimate objective was to acquire development rights.

Administering Ventures

Before launching venture programs, companies must decide to what extent they wish to be involved in administering their investments. Many prefer passive roles and turn to external managers, usually partners of independent funds, to handle their investments. Other firms choose to manage venture programs themselves, especially if they want to maintain a close relationship for strategic or financial reasons. Of course, some companies start out using external managers for their venture projects and gradually assume some or all of the management responsibility.

[6]Carl Bewerunge, *Providing For Spin-Offs.* Transcript from a presentation at a Conference Board meeting: "Job Creation in Action: Methods That Work," Brussels, March 6-7, 1985.

External Administration

The partners of independent venture capital funds assume management responsibility for the monies entrusted to them by corporations and pension funds. These managers keep investors abreast of the performance of the various small companies in which funds are invested. Depending on the agreements worked out with corporate investors, other information of special interest may also be passed along.

Reliance on outside executives to administer venture investments does not completely eliminate the need for supervision, however. Often a committee or corporate executive from the investment, pension or development area serves as a liaison with fund partners and keeps senior corporate management advised.

Choosing Outside Funds

How do companies pick the venture capital funds in which they invest? Selection often hinges on the fund's track record, the personal accomplishments of fund managers and business philosophies.

While potential investors realize that a history of success is not necessarily an accurate barometer of a manager's performance, those with impressive score cards are ordinarily preferred. The educational achievements and work experience of the venture capital partners are also of interest to corporate investors. Strong academic and business credentials (especially in venture-related activities) are fairly standard requirements.

In addition, companies review the investment postures of venture capital partnerships. They are interested, for instance, in the industries in which investments are made, in how partners work with developing and investor companies, and whether assistance of various kinds from corporate investors is welcome. External venture capital managers whose business philosophy tends to parallel that of investors score critical points in the selection process.

Would-be venturers will also compare the fees charged by the partnerships under consideration. Some corporate investors even examine the schedule by which monies are paid in—entirely at the outset or in installments at different times or stages of development—for compatibility with their own plans.

Internal Administration

Companies that make direct investments in venture projects have little choice but to manage such commitments, but for many internal administration is more a matter of preference than of necessity. Table 5 points out the various approaches to internal management of ventures taken by respondents.

Forty-three, or three out of four, of the 58 respondents who gave details about their proprietary venturing programs have organized wholly owned subsidiaries or other special units to manage their venture investments. The territory of these organizations can and often does include the entire gamut of venture projects, from selecting and monitoring investments in independent venture capital partnerships to supervising relationships in strategic alliances and providing guidance to "intrapreneurs" (see box).

Table 5: Internal Administration of Ventures in Participating Companies

Administrator	Number of Mentions by U.S. Firms	Number of Mentions by All Other Firms	Total
Venture management subsidiary or other special units	33	10	43
Corporate group, division or department	6	6	12
Designated executive	3	-	3
Total	42	16	58

Total number of firms answering this question: 58.

For the most part, surveyed companies report that the management groups of their venture subsidiaries are fairly small. One subsidiary has a president, an executive vice president, three vice presidents, and a support staff; a second firm has four managers and a part-time secretary; while a third "consists of six professionals and is structured to function inter se as a partnership with three principals or partners (one of whom acts as managing principal) with three associates." Officials of these venture subsidiaries often have legal, financial, technical or marketing backgrounds that assist them in their roles as venture capitalists.

The composition of special venture management units varies from company to company, but members often include representatives from several functions. For example, the venture management group of one domestic manufacturing company includes a corporate vice president, an individual from the corporate financial staff, and members of a small new business development group. Another management group consists of "all the business functions essential to its performance and success."

A manufacturer that utilizes a variety of venture forms organized a special unit to consider venture proposals that lacked support within the corporation. Explains its Director of New Opportunity Development: "Aside from the strategic thrusts of our existing operating groups and business units, their counterparts in the shared resources areas, and in R&D, the corporation has created a Venture Board, which is composed of senior management personnel, to review new business proposals that have difficulty achieving sponsorship elsewhere. The Venture Board reports at the corporate level and has an executive staff to manage the deal flow and to coordinate the corporate infrastructure necessary to facilitate the process."

In fifteen of the 58 participants, responsibility for venture management rests with existing company components or functions—groups, divisions, departments—or with individual executives. Although 20 of the 78 companies with proprietary venturing activities did not specify how they administered their programs, several report that they have no formal venture management organizations; rather, they rely on existing corporate entities to oversee those investments.

Structuring for "Intrapreneurial" Efforts

Some companies, hoping to spur profitability by introducing new products or by entering untapped markets, believe internal venturing offers better prospects than acquisitions or other growth avenues. They encourage this through a variety of organizational approaches.[a] For example:

- In one domestic manufacturing company, employees in R&D are encouraged to become intrapreneurs. They are given several operating options, ranging from fairly limited to virtually complete freedom. Regardless of the path chosen, intrapreneurs usually enjoy the support of senior R&D managers, and intrapreneurial groups are "sponsored, mentored, facilitated" by the parent's autonomous venture subsidiary.
- Another manufacturer forms venture teams with personnel drawn from a variety of existing corporate functions. These teams, usually of about five people, are launched without products to produce or markets to enter. Initially, they devote their efforts to brainstorming and to searching for growth opportunities. A corporate development committee devises a strategy, oversees funding, measures progress, and decides when an evolving venture is ready for commercial deployment in an operating unit.
- Several participants have established autonomous units to develop growth opportunities. These units contain or have access to the staff and functions—finance, marketing, engineering, for example—necessary to attain their goals. Units operate with little or no parental direction but are under the aegis of specially appointed boards or committees or of sponsoring operating divisions or groups.

[a] For detailed review of organizational approaches, see Michael G. Duerr, *The Commercial Development of New Products*. The Conference Board, 1986, Report No. 890.

Reporting Relationships

Reporting relationships vary among surveyed companies. In those with venture subsidiaries or with special units devoted to venture activities, venture managers often report to the sponsoring firm's senior management or, in a few instances, directly to its board of directors. In declining order of survey mention, venture managers report to:

- Chief executive officers
- Vice chairmen
- Vice presidents of planning, development, R&D, finance
- Chairmen of executive committees

Where distinct venture management organizations do not exist, reporting levels are generally somewhat lower in the management hierarchy. For example, ranking above venture managers in the chain of command are vice presidents of development, functional managers, and vice presidents of groups or divisions.

Compensation Arrangements

While compensation of external fund managers is usually covered by agreements on management and profit-sharing fees,

that of internal administrators of venture projects depends on individual company practices. Special compensation arrangements for in-house venture managers exist in 14 responding firms, of which 13 have headquarters in the United States.

Incentive arrangements usually appear in venture subsidiaries and in other units that stress financial returns among their objectives. In an effort to motivate and retain internal managers, compensation packages are often tied to performance through profit-sharing agreements similar to those enjoyed by independent venture fund managers.

The special compensation plans of some contributors contain unusual twists that differentiate them from the basic percent-of-profit approach. An executive of a U.S. manufacturing company explains his firm's policy: "The venture management team does not receive special compensation—save that its incentive bonuses are tied into venture company objectives . . . . The general managers and key staff of operating companies within the venture company do receive special compensation. This includes annual incentives tied to milestones for their business; and an opportunity for major earnouts at the end of a business plan period (three to five years). Additionally, intrapreneurs who successfully develop and commercialize a product receive a significant cash payment and a significant award of the parent's stock vested over three years."

Arrangements may include such features as stock options. In one company:

> "Each venture company is initially 100 percent owned by the parent through an acquisition of 100 percent of the stock or through an initial cash infusion equal to an amount estimated to be needed to complete the development of the product.
>
> "A special compensation package we have developed involves the issuance of stock options (primarily incentive stock options) in the individual companies which are exercisable in expiring increments over several years. The individual enters into a repurchase agreement with the company that allows the company to buy back the stock by the end of the eleventh year. The individual can sell the stock back earlier at his discretion and must sell it back if he leaves the parent or any of its subsidiaries. The repurchase price, since there is no public market, is determined by a formula developed to simulate the market price based on sales growth, profit and asset turns. This gives the individual the opportunity of financial reward if the company is successful."

Another firm ties rewards to venture milestones: "We have developed special compensation programs to reward new business groups for successful accomplishment of the business goals. These rewards recognize three phases of venture developments:

- *The idea phase* recognizes the inventor or originator of a new business concept.
- *The bundle and test market phase* recognizes the performance of the team in developing the product and marketing plans. The award is paid only after the product demonstrates its success in a live test market.
- *The commercialization phase* rewards key team members with a profit-sharing program as the new business begins to contribute positive earnings."

One manufacturing firm takes a more traditional approach:

> "One area where we do not deviate from standard corporate procedure is in personnel matters. All venture subsidiary employees are corporate employees and get standard corporate benefits. The only exception is that the executive bonus, a standard corporate benefit for mid- and upper-level exempt employees, is tied to the performance of a specific start-up rather than to the performance of the company or collection of operations, as is typical for the rest of the corporation.
>
> "In a couple of cases we have a payout formula for the participants, based specifically on performance of the venture, which is designed to minimize what might happen for a typical venture capital start-up at an initial public offering. The magnitude of such a one-time payment is limited both because of lower risks invoived by the individuals and because of the need to keep a semblance of consistency throughout the organization. Despite the lack of extraordinary incentives, we have had no difficulty recruiting and motivating the staff of our start-ups."

Problems and Responses

Twenty-five respondents reported problems of varying severity in connection with their venture capital programs. The problems fall into three broad categories:

- Management difficulties
- Operational snags
- Conflicts of interest

Management Dilemmas

A few companies encountered difficulties with joint ventures or strategic alliances. Their experience demonstrates that friction over policy issues may arise when a partner changes objectives or faiis to stick to an agreement. Unless such disputes are resolved, it is sometimes necessary for one or more participants to bow out. This is not the only alternative, however, as one executive explains: "When addressing problems in ventures, many times the first reaction is to get out of the venture and go it alone. Obviously, this is not always possible and, therefore, corrective actions are required. Probably the most often used solution is a change of people in the venture and, on the partners' side, in liaison personnel. Other corrective measures include reestablishing objectives and venture mission, establishing alternate levels of communication, refinancing, or looking for an additional or substitute partner(s)."

Some venture sponsors, particularly those that confine investments in emerging concerns to minority holdings, complain that sometimes their decision-making authority is too limited. This is especially painful when drastic action to protect an investment is needed. Increased investment, though often contrary to policy and lacking in appeal, may at least remedy or salvage the project.

Several of those queried experienced difficulty in administering new, intrapreneurial businesses. The challenge lies in guiding intrapreneurs without undermining their autonomy. Some venture sponsors attempt to overcome this problem by offering intrapreneurs considerable operating leeway, by negotiat-

ing mutually acceptable working relationships, by "jawboning," and by demonstrating a determination to make arrangements work.

A related problem for many firms is designing a compensation policy that is equitable for individual risk-takers as well as corporate sponsors. Often, this issue is resolved by devising compensation schemes that enable venturers to share in the profits of their endeavors.

Operational Difficulties

Several sponsors reported operational difficulties, such as getting all parties—subsidiaries, divisions, groups, entrepreneurs and managers—to work together in a way that would optimize results. Some firms choose to take whatever steps are necessary to promote cooperation and to improve communications among the various venture participants.

As the Executive Vice President of a domestic manufacturer put it: "The major challenge in structuring the venturing activity is to take fullest advantage of the technical and market strengths which exist within the corporation while achieving the 'broadening of horizons' for the corporation, which is an inherent goal. We have attempted to strike that balance by establishing a venture organization that is not directly attached to any single operating unit within the corporation but that has working relationships with each of them on an individual program or project basis. Thus the strengths of a given operating unit can be brought to bear in commercializing a specific opportunity, thereby maximizing the probability of success, while opportunities which are beyond the scope of a single operation, or which cross interdivisional boundaries, can be readily accommodated."

A few companies complained about the inordinate amount of senior executive and even board attention required when venturing is highly visible. They expect, however, that the "excess" time devoted to venture activities will diminish as top management gains experience. Should time remain a problem, reassessment is likely.

Other companies expressed concern about disappointing financial returns, which they are attempting to improve by employing more sophisticated management techniques and by being more cautions about investment choices.

Conflicts of Interest

Two respondents, both venture arms of U.S. financial institutions, voiced concerns about possible conflicts of interests arising from their venturing operations. Potential conflicts arise when the sponsor holds debt and its subsidiary holds equity in a venture organization that experiences financial difficulty. One respondent addressed the situation by refusing to "take a leadership role in the equity capitalization of a company where one of our affiliate banks is the lead lender;" in the other, "third parties were brought in to provide input."

Progress Appraisal

Participants take stock of the progress recorded by their venture investments at intervals that range from every quarter to once yearly. For the most part, measurements compare financial performance and other variables with venture targets. As Table 6 indicates, the majority of survey respondents are satisfied with the results of their corporate ventures. However, many hedge assessments of their venturing objectives. This is in part because the final outcome, especially in financial terms, can only be determined upon liquidation or maturation of the investment.

Table 6: Satisfaction with Accomplishment of Venture Objectives

Level of Satisfaction with Results	*Number of Mentions*		
	U.S. Sponsors	*All Other Sponsors*	*Total*
Pleased to date	21	7	28
Too early to make a judgment	9	4	13
Varies	6	-	6
Less than fully satisfied	2	2	4
Total	38	13	51

The consensus is that patience is essential to the assessment of venturing achievements. However, as the General Manager of a British manufacturer's new-opportunities department makes clear, deciding whether to desist or to proceed with venture undertakings is anything but easy: "We know, and accept, that cumulative positive cash flow on major R&D product development can take a decade or more. It is, therefore, somewhat surprising that we tend to be more impatient about corporate venturing and have a tendency to 'pull the flower up by its roots' to see how it is going. There is no predetermined appraisal system, but an on-going look at our expenditures (particularly when trading results have been poor) often means that new businesses get reviewed more often than is really 'fair.' And we have hesitated to stay with some when—as happens more often than not, despite our best endeavors to produce realistic business plans—they need more money. We do usually find the money, even perhaps, when a decent burial might have been more appropriate. Learning when to stop, as in R&D, is something we have to develop."

More than half of those expressing an opinion on the effectiveness of venture programs are satisfied thus far, and another quarter are withholding judgment until investments mature. But some measure of dissatisfaction exists among the remaining respondents. Six companies experienced mixed results: some goal has been accomplished (e.g., financial return), but another has not (e.g., technology transfer). It could also be that one form of venturing achieved the desired results while another failed. Four companies were less then fully satisfied with venturing results, and may refrain from returning to the arena soon. Observes the Director, Strategic Planning, of a domestic manufacturing company: "All in all, the general level of satisfaction with recent venture efforts is not high. The two most recent ventures are in serious financial difficulties, and the burden on management time is indeed excessive. From a planning viewpoint, there exists a need for future venturing, perhaps under a different structure, but the current experience has dimmed the outlook for at least the near future."

The Final Outcome

What finally happens to venture capital investments in emerging companies? Outcomes vary but largely depend on the extent to which the objectives set for the investment are met and on investor preference. One of the following results is likely:

- The emerging company flourishes and goes public or is sold to other interests. (Either course permits venture capital partnerships or other investors, including direct corporate investors, to recoup their investments with appreciation.)
- Corporations may acquire small firms in which they have made investments, work out special agreements with them, or simply maintain long-term investment positions. In the case of spin-offs, investments may be retained or eventually sold. Promising internal start-ups may grow and become major underlying components of sponsoring parents, or they may be divested.
- Strategic alliances may dissolve when they no longer offer mutual benefits or culminate in mergers.
- Pension fund venture capital holdings are sold in accordance with the investment guidelines of individual companies or managers.
- Investments in unsuccessful organizations, whether made by independent partnerships or directly by corporate sponsors, may be liquidated at distress prices or simply written off.

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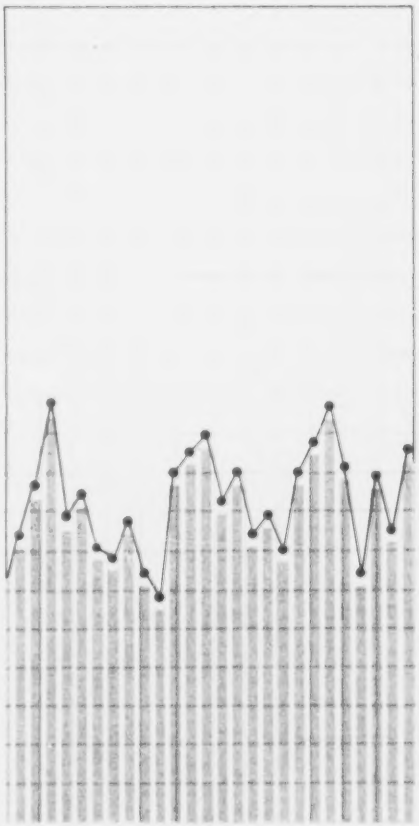

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